THE UNDER SECRETARY OF DEFENSE

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ACQUISITION AND TECHNOLOGY

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MEMORANDUM FOR SERVICE ACQUISITION EXECUTIVES
DIRECTORS, DEFENSE AGENCIES
DIRECTOR, DEFENSE LOGISTICS AGENCY

SUBJECT: Incentive Strategies for Defense Acquisitions

Incentives exist in every business arrangement. The effective application of incentives is key to building successful business arrangements that jointly maximize value for all parties. It is essential that the Department adopt incentive strategies to successfully attract, motivate and reward traditional and non-traditional contractors, thus ensuring successful performance. Incentive strategies must also maximize the use of commercial practices to enhance our ability to attract non-traditional contractors.

Incentives can be monetary or non-monetary, and should be positive but balanced, when necessary, with remedies for missing specific program targets or objectives. They can be based on price, cost, schedule and/or performance. Regardless of the final composition and structure of the incentive(s), the goal is to encourage and motivate optimal performance.

Historically, choice of contract type has been the primary strategy for structuring contractual incentives. With the exception of competitive firm fixed price awards, procurement incentives have predominately been based on projected or actual costs. This practice, while effective where costs cannot be precisely estimated, does not always ensure that contractors maximize efficiencies regarding underutilized or inefficient operations, practices and facilities. Such incentives can have the opposite effect of rewarding industry for the retention of inefficient practices or underutilized capability. When cost-based incentives are used, care should be taken to ensure that these unintended consequences do not occur.

Alternatively, non-cost based incentive strategies more closely approximate commercial agreements and are based on clearly defined performance objectives or product functionality rather than detailed requirements. Such agreements reflect joint goals of efficiency and effectiveness, reflect acceptable risks for all parties, and establish performance metrics. Program teams should structure incentive strategies to attract non-traditional defense entities, as well as to reward successful performance of traditional defense firms. Thorough market research should be conducted to develop a better understanding of the business strategy from both the government's and the contractor's viewpoints, leading to behavior that jointly achieves the mutual goals of all parties (e.g. best value acquisitions and targeting high performance based on best business practices).

The attached guidance amplifies existing policy regarding use of incentives in defense acquisitions. In addition, to assist the acquisition workforce, an incentive guidebook is being developed based on work conducted by the Army and the Massachusetts Institute of Technology. This guidebook will be available at www.acq.osd.mil/ar in January 2001.

Attachment:
As stated

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INCENTIVE STRATEGIES AND TOOLS FOR ACQUISITION

GENERAL POLICY GUIDANCE

Suppliers should be rewarded for adopting business processes and principles designed to reduce costs and cycle time while maintaining schedule, achieving performance expectations and maximizing efficiency. DoD business strategies should focus on the overarching business considerations related to each acquisition strategy and address the following objectives:

- Use incentives tailored to the specific business case to achieve maximum benefit for both parties.
- Assess the most critical issues related to specific acquisitions, and design incentives to ensure optimal results.
- Design strategies to reflect an understanding of the business case from industry's perspective. Profit, earnings per share, cash flow and return on investment are important industry considerations in entering into business relationships.
- Recognize and reward contractors that strategically focus on efficient and effective management practices, thereby reducing unneeded capacity and maximizing overall value to the customer (e.g., lean industry principles and best practices should be recognized and rewarded including maximum practicable use of small businesses in subcontracting.
- Recognize that a requirement's structure drives business solutions. Match the essential program objectives and potential incentive arrangements early on, and communicate objectives to industry.
- Agree on incentives and remedies to ensure successful business relationships.
- Strive to be creative and resourceful; maximize continuous improvement and joint problem solving, with a focus on performance outcomes.
- Integrate commercial and commercial-like best practices into defense acquisitions to the maximum extent possible to achieve efficiency and effectiveness for both parties.
- Make incentives realistically reflect performance objectives and standards so that they are measurable and attainable.
- Communicate expectations, assessments and any change in focus clearly to maximize the potential performance.

Performance incentives include a broad spectrum of business considerations and range from economic to non-economic and cost-based to non-cost based tools, processes and practices. They can also be multidimensional or targeted to specific deliverables or effort. Some incentives may be traditional while others new and innovative, reflecting an understanding of the increasingly rapid pace of change in the commercial marketplace. Performance goals should be achieved through an appropriate contract structure; one that may reflect multiple incentives or rewards.

PERFORMANCE-BASED BUSINESS ENVIRONMENT

Acquisition strategies should use a performance-based business environment (PBBE) approach to enable government customers and contractor suppliers to jointly capitalize on commercial process efficiencies to improve acquisition and sustainment processes. The PBBE shall be structured to:

- Convey product definition to industry in performance terms.
- Use systems engineering and management practices, including affordability, integrated product and process development, and support, to fully integrate total life-cycle considerations.
- Increase emphasis on past performance.
- Motivate process efficiency and effectiveness up and down the entire supplier base (i.e., primes, subcontractors and vendors) through the use of contractor-chosen commercial products, practices and processes.
- Encourage life-cycle risk management as opposed to risk avoidance.
- Simplify acquisition and product support methods by transferring tasks to industry where cost effective, risk-acceptable commercial capabilities exist.
- Use performance requirements or conversion to performance requirements during reprocurement of systems, subsystems, components, spares and services beyond the initial production contract award and during post-production support to facilitate technology insertion and modernization of operational weapons systems.

INCENTIVE TOOLS

Some specific incentives are identified here, not to limit the potential for using others, but to encourage broader thinking and implementation of effective incentives.

Contract Length Considerations

Contract length should be considered as part of an acquisition strategy when appropriate. Long-term contract relationships—beyond five years—can be effective in building and maintaining strategic relationships with suppliers. In addition, long-term supplier relationships enable DoD to expand its supplier base as companies once unattracted to the Department begin to compete for longer-term contracts. Acquisition leaders are reminded to include requirements for small business subcontracting wherever longer-term contract provisions are planned.

Contracts covering requirements for more than one fiscal year provide benefits that include reduced start-up costs, maintenance of a stable workforce, increased competition from small businesses and acquisition streamlining. These benefits are key to the reengineering and streamlining of the Department's business practices. Without long-term contracts, the contractors may be unable to justify making the necessary investments, and therefore competition may be diminished.

There are four acquisition strategy considerations that must be addressed whenever contract duration beyond five years is planned. These conditions are appropriate to both competitive and non-competitive strategies.

1. The strategy must articulate when and how the provisions of the Competition in Contracting Act (CICA) will be addressed, including at what point in the future it will be re-addressed (e.g. in a sole source Justification and Approval or in a future competition).

2. Continued performance or contract term must be conditioned on continual successful performance. Performance outcomes must be clearly articulated.

3. Price guarantees, options and cost-based ceilings should be agreed upon by both parties, either competitively or non-competitively, to ensure that commitments are established and maintained throughout the period of performance. Acquisition personnel are urged to build in flexible pricing guarantees or alternatives (e.g. ceilings or price curves) to adapt to budget and quantity fluctuation.

4. Contract terms must be consistent with statutory funding limitations on the purpose and amount of appropriated funds expenditures. Availability of funds provisions are key to the use of long term contracts.

<u>Strategic Supplier Alliances</u>

Strategic supplier alliances with industry partners strive to mirror commercial best practices and achieve a basic transformation in the way competition for business occurs and value to customers is increased. A strategic supplier alliance model migrates the Department from a transaction-based contract approach to a commercial portfolio management model priced according to demand. Such alliances have been forged between the Defense Logistics Agency (DLA) and Honeywell Incorporated (catalog prices); DLA-Honeywell-Boeing (parts management); DLA-Hamilton Sundstrand; and DoD-Sarnoff Corporation (research and development). The DoD Change Management Center (http://www.acq.osd.mil/ar/cbe) has more details on strategic supplier alliances.

Strategic supplier alliances strive to create long-term, mutually beneficial partnerships. The following factors support the decision to enter into a long-term strategic alliance agreement:

1. A good business case (other than administrative convenience) for the longer duration exists and is documented in the justification and approval or elsewhere in the contract file.
2. Only sole source items that are unlikely to become competitive are on the contract, and a process for checking items periodically to ensure they have not become competitive is in place. The competition review should not be tied to option exercise (for options longer than one year).
3. A method for removing items from the contract if/when they become competitive (e.g., add/delete clause, termination for convenience clause) exists.

<u>Performance-Based Payments</u>

Performance-based payments, instead of cost-based progress payments, are the preferred way of providing financing payments under fixed-price contracts. Performance-based payments offer the following potential benefits for both the Government and contractors: enhanced technical and schedule focus, broadened contractor participation, reduced cost of administration and streamlined oversight, enhanced and reinforced roles of program managers and integrated product teams and increased cash flow. See the USD (AT&L) November 13, 2000 policy memorandum on Use of Performance-Based Payments for more details.

<u>Performance Incentives</u>

Performance incentives are designed to relate profit to the contractor's achieved results based on specified targets. For services such as equipment maintenance, these characteristics may include mean time between failure (MTBF) or mean time to repair or system availability rates (in-commission rates). Regardless of the measure, performance incentives must be quantified and correlate rewards to performance. Remember that a performance-based requirement can also be an incentive and can significantly impact what objectives the contractor pursues. For example, a contract for spare parts at a fixed price per part encourages a contractor to sell many spare parts. A contract for "all spare parts and maintenance required to keep vehicle operational to 98 percent availability rate" and paid as a fixed price per vehicle operational hour, will likely result in fewer spare parts, greater dependability, and less maintenance required.

Schedule Incentives

Schedule incentives focus on getting a contractor to exceed delivery expectations. They can be defined in terms of calendar days or months, attaining or exceeding milestones, and meeting rapid response or urgent requirements. Acquisition teams should also consider adjusting government delivery schedules to correspond with commercial production runs as along as mission needs are met.

Award Fee Contract Arrangements

Award fee contracts are a tool that subjectively assesses contractor performance for a given evaluation period. They allow contractors to earn a portion (if not all) of an award fee pool that is established at the beginning of the evaluation period. The agency unilaterally determines the amount of earned fee based on evaluation factors established in an award fee plan. In the context of PBSA, the award fee evaluation is based on a subjective assessment as to the extent to which the contractor exceeds the minimum acceptable performance standards.

Past Performance

Appropriately leveraging past performance to improve ongoing performance can be another incentive tool to ensure successful performance. When negative or positive performance assessment information is promptly communicated to the contractor, it becomes an effective way to motivate the contractor to improve performance or to reinforce exceptional performance. This information could affect decisions such as the exercise of option awards or the contractor's ability to receive future contract awards. When adequately documented, poor past performance information could be the sole reason for a contractor to not receive future contract awards. Keep in mind that the integrity of a past performance evaluation is essential.

Competition Considerations

Win-win relationships can be facilitated in both competitive and non-competitive environments that reward the contractor and increase the probability that the goods and services will be successfully delivered. Source selection strategies should encourage flexible pricing/incentive strategies, and performance-based requirements. Acquisition teams should emphasize the importance of pre-solicitation conferences, draft requests for proposal and rigorous market research.

Remedies for Non-Performance

Acquisition strategies must specify procedures or remedies for reductions in contract value (e.g., profit or contract length) when services are not performed or supplies do not meet contract requirements. In cases where commercial item acquisition procedures are used, agencies should rely on contractors' existing quality assurance systems, to the maximum extent practicable, as a substitute for unique government acceptance procedures. As always, agencies should not pay for services that do not meet performance requirements.